SKIDDING OFF THE ROAD TO RECOVERY:
New Risks for the Advanced and Emerging Markets of the G-20

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Framing the Issue

Advanced economies as a group are skidding off the road to recovery; emerging markets are dealing with domestic policy tensions related to maintaining strong growth while keeping inflation under control.

Leaders of the major advanced economies face dire economic circumstances and have little room for domestic policy maneuver. A series of adverse shocks, coupled with political wrangling that has stymied effective policymaking and added to uncertainty, has crippled growth in advanced economies. Emerging markets have kept up their end of the bargain by maintaining strong growth so far, but the battle against domestic inflation and weaknesses in major export markets are beginning to affect their growth as well.

Policy Considerations

Debt crises, weak employment growth and policy dithering in the major advanced economies have exacerbated global economic uncertainty. The perception of rising risk and inadequate policy responses has shaken financial markets and dented confidence around the world. Reflecting widespread anxiety and fear about global economic prospects and the lack of obvious policy solutions, global financial markets remain on edge.

The recovery in the United States has been hurt by a withdrawal of fiscal stimulus in the short run and little decisive action in tackling the long-term debt problem, exactly the opposite of what is needed. Political wrangling and weak employment growth have contributed to declines in business and consumer confidence, with these factors feeding off one another and stunting the recovery. Japan is still reeling from the aftermath of the earthquake and tsunami, with political instability contributing to a lethargic economy that is unable to shake off its torpor. Most macroeconomic indicators—including GDP, employment and exports—are weak and show little sign of recovering anytime soon. The German economy remains relatively bright but overall short-term macroeconomic prospects for European economies are grim as they deal with fiscal austerity programs and banking systems under considerable stress.

Emerging markets continue to perform well but remain under pressure, with concerns about persistently high inflation and, in some cases, frothy asset markets. The challenge for these economies is to maintain high growth while tamping down inflation, a difficult proposition even in good times and particularly so when the advanced economies are dragging down global growth and adding to emerging markets' policy complications. Capital flows to emerging markets have shrunk as global investors retreat to safe havens, taking some of the pressure off these economies.

China's economy continues to forge ahead, with GDP and industrial production still growing strongly and robust domestic demand offsetting a decline in export demand. There are signs of increasing domestic policy tensions as concerns about high inflation square off against the desire to maintain strong domestic growth. The odds are about evenly balanced between a soft and hard landing, with global economic conditions being the wildcard. Continued weakness in China's major export markets, Europe and the U.S., has already affected its export growth and there is a prospect of new domestic demand stimulus measures to offset this external drag on growth.

India's financial markets have cooled off and GDP growth has slowed slightly, but foreign trade and industrial output continue to grow strongly. In Brazil, GDP and industrial production growth have both weakened. In these and many other emerging markets, continued strong credit growth even as confidence indexes are weakening indicates a major challenge for policymakers in maintaining strong growth while keeping inflation bottled up.

Emerging markets may find it difficult to continue being the drivers of global growth for much longer if the policies in advance economies fail to restore their own economic growth and, instead, just add to global financial instability.

The European debt crisis is adding to global uncertainty, which is one of the factors adding to the fragility of the global recovery. Continued political wrangling is worsening the European debt crisis by the day. There are encouraging signs on the policy front in Europe in recent days, but there remain serious concerns about the measures being too little and too late.

Currency wars have broken out into the open, with even many advanced economies getting drawn in. Japan and Switzerland have intervened extensively in foreign exchange markets to prevent rapid appreciation of their currencies. The currency spat between China and the U.S. has heated up and could turn ugly as both sides attempt to flex their muscles. The world economy can ill afford heightened trade tensions that would add to global economic uncertainty and further affect prospects for a sustained recovery.

The global financial turmoil and the search for safe havens have temporarily moved other emerging markets to the sidelines of the currency wars as they no longer face pressures for currency appreciation. But there is a general awareness in these economies that they may have won at best a temporary respite from capital inflow surges.

Action Items for the G-20

Policy options for the advanced economies are being hemmed in by economic and political circumstances. Fiscal policy is constrained by crushing debt burdens and monetary policy is reaching its limits, with further unconventional monetary easing likely to yield a low ratio of reward to risk. Advanced economy central banks already have expanded their balance sheets massively in ways that carry many economic and political risks. For the foreseeable future, these central banks will continue to face the twin burden of supporting growth and preventing financial panics.

In advanced economies, the lack of political consensus is a key constraint in fashioning effective and credible policy measures. Domestic political tensions in the major economies and cross-border policy tensions are adding to economic uncertainty and hindering effective policy responses to the faltering recovery.

For its own sake and that of the world economy, Europe must act quickly to implement concerted and forceful measures to forestall a financial and economic meltdown that could have global repercussions. In the U.S., the fragile state of the recovery calls for more aggressive short-term fiscal measures, despite all the risks that rising deficits entail, and a more balanced approach to long-term fiscal discipline that includes revenue measures rather than just spending cuts.

The world economy is entering a difficult and dangerous phase, where there are no easy or costless policy solutions but policy paralysis also carries enormous risks of unraveling the feeble recovery.